Market Downturns and Risk

July 2021

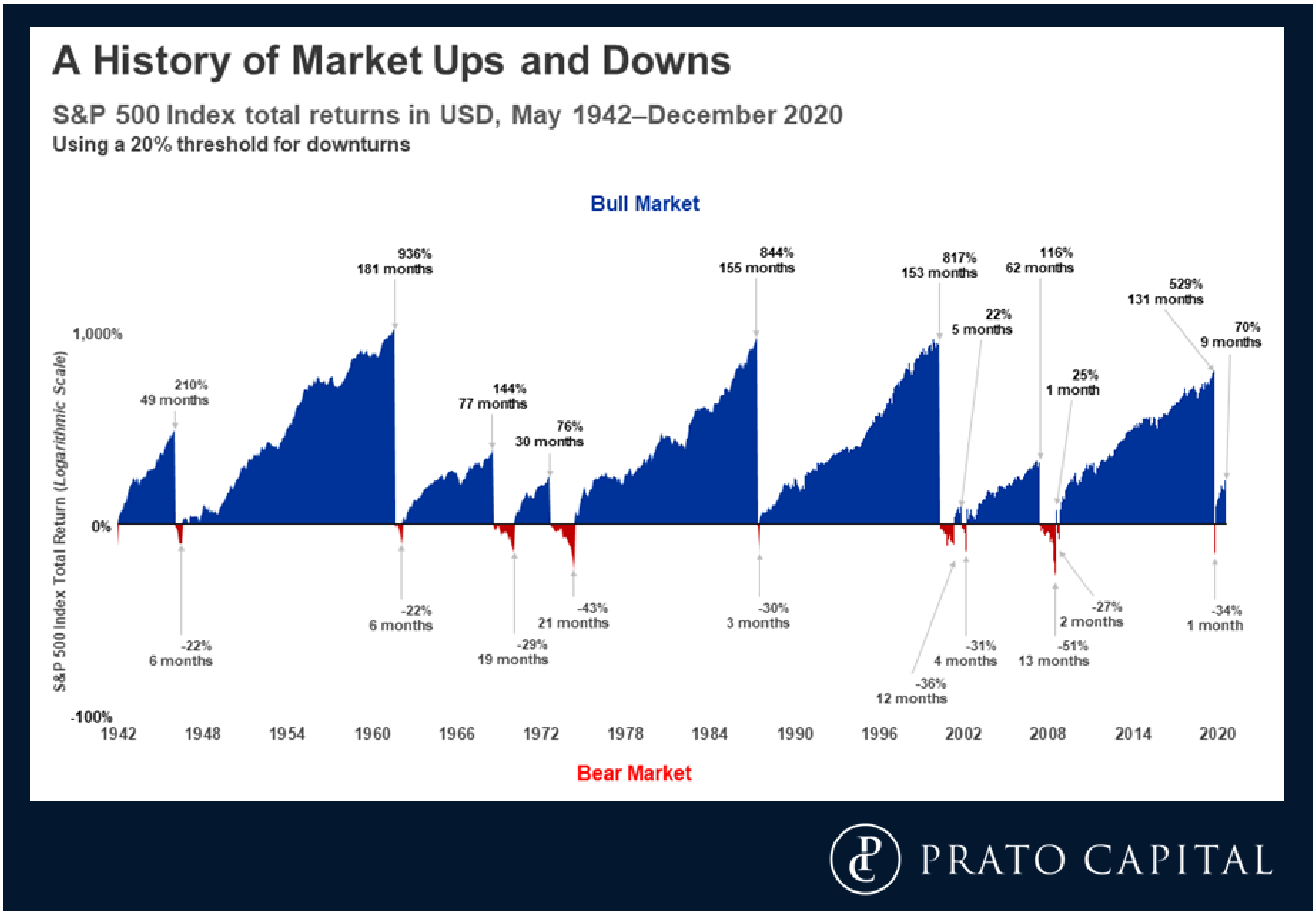
It may seem like a strange topic considering the stock markets have been setting record highs for months now, but investors should consider the impact of risk and any possible market downturns before markets change direction.

Market Corrections and Bear Markets

Market corrections and bear markets are a normal part of investing. A market correction is a decline of more than 10% from market highs and a bear market occurs when the correction is greater than 20%. Corrections and bear markets can occur for individual securities or indices like the S&P 500. Since 1942, there have been 30 times the S&P 500 has declined between 10% and 20% and 12 declines over 20%. On average, markets have declined over 10% about every 2 years. But the average does not tell the whole story. In both 1990 and 2018, there were two market corrections in those years and between 1971 and 1980, nine out of the ten years included either a bear market or a market correction. After 1990, the next market correction was seven years later in 1997. This shows that market corrections and bear markets do not happen with any predictable pattern, and this is part of why market timing is impossible.

While market corrections and bear markets are not uncommon, it is important to remember that most of the time the stock markets are in a bull market. Chart 1 below shows both the Bear Markets and Bull Markets from May 1942 to December 2020. This chart shows that markets rise for much longer periods of time than market declines during bear markets and the percentage gains over a bull market are significantly greater than any losses from bear markets.

Chart 1:



Risk

Since late March 2020, the S&P 500 has almost doubled, with a return of over 94% on June14, 2021. It was unexpected for many and very welcome for almost everyone after seeing the market declines earlier in 2020. As the markets have risen, headlines in the media have shown some outsized gains in areas like SPACs, MEME stocks, and cryptocurrencies with many investors increasing the risk in their portfolios by adding these assets. For assets like these, speculation has become the new normal and this can greatly increase risk.

There are several different types of risk associated with both investors and their portfolios. For investors, we often speak of risk tolerance. Generally, this is the amount of potential decline in value of a portfolio that the investor can tolerate before selling those declining assets. It is easy to feel more risk tolerant when stocks and portfolio values are rising causing investors to take on more risk, but when stocks and portfolio values are dropping most investors want less risk. This often leads many to buy high when markets are rising and sell low as markets decline.

There is a certain amount of risk associated with investing in the stock market. One way to reduce or manage the risk of a portfolio is to have a diversified portfolio of stocks and bonds. Generally, stocks are more volatile than bonds but often have better returns over longer periods of time. A portfolio of stocks and bonds based on the investors risk tolerance reduces risk and volatility while still capturing gains from stocks. Periodic rebalancing keeps the amount of stocks and bonds in line with the investors risk tolerance.

Another way to reduce risk in a portfolio is to diversify the stock holdings with a broad portfolio that includes US, international and emerging market stocks. Our February 2020 newsletter discusses the benefits of a globally diversified portfolio. A broad-based global portfolio decreases overall risk and volatility while increasing the chances of capturing returns where and when they happen.

Conclusion

Very few investors think of risk, market corrections or bear markets when stocks and their portfolios are rising. The truth is this is the perfect time to evaluate a portfolio for risk and diversification before markets turn volatile.

At Prato Capital, do we see a market correction or bear market in the future? Yes. We don’t know when, but history has shown that investors will see many market corrections and several bear markets over their investment lifetime.

Having an investment plan with a long-term outlook that includes a broad based, balanced, and diversified global portfolio will make it easier for investors to stay on track through market downturns and will help keep them on track toward reaching their financial goals.

“The time to repair the roof is when the sun is shining.” - John F. Kennedy